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Passive Activity Loss Disallowance Rules for Partners

American Institute of Certified Public Accountants
Washington, DC
www.aicpa.org/tax



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Loss Ordering – Three Limitations

1. Partnership or S corporation basis rules
2. At-risk rules
3. Passive loss rules

Ordering rule: first determine if there is sufficient basis, then whether the taxpayer is at-risk, and finally whether the losses are passive. If there is insufficient basis to absorb losses, then the other two limitations need not be considered.



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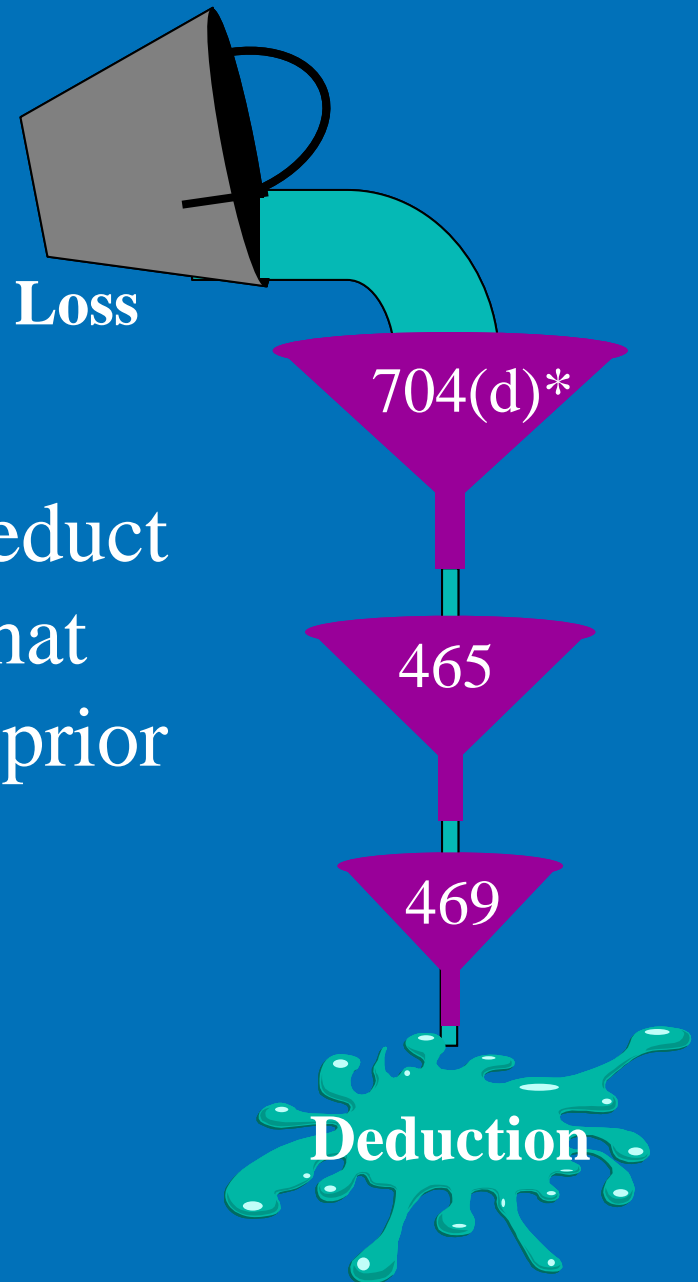
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Loss Limitations

Bucket O' Loss

A taxpayer can never deduct more than the amount that flows through from the prior limit

*Or basis calculated under another section of the Internal Revenue Code as appropriate



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Passive Activity Loss Limitation

Aggregate losses from passive activities are allowed only to the extent of aggregate income from passive activities

- \$25,000 exception for active participation in rental real estate
 - Phases out for income over \$100,000 / \$150,000

Disallowed losses are carried forward

- No limit on carryforward
- Treated as losses incurred in the following year
- Suspended losses become non-passive on disposition of the activity



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Taxpayers Subject to Section 469

Individuals

Estates and Trusts

Closely-held C corporations

- Passive losses may offset active income but not portfolio income

Personal Service Corporations

Not partnerships or S corporations, but
partners and shareholders may be subject
on their distributive share



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Categories of Income

Three primary types

- Active
- Passive
- Portfolio

Net income from each type fully taxable

Net loss from passive generally not deductible

- Special rental real estate allowance
- Deductible upon fully taxable disposition
- Oil and gas activity exception



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Definition of Passive Activity

Any trade or business in which taxpayer does not materially participate

Most rental activities (unless a “real estate professional”)

For real estate professionals, a rental activity in which taxpayer does not materially participate



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Activities that are Not Rental

Short-term rentals

- Average use: 7 or fewer days

Significant personal services

- Average use: 30 or fewer days with significant services

Extraordinary personal services

- Rental incident to services

Incidental rentals

Nonexclusive customer use

Property provided to flow-through entities



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Nonpassive Income

Portfolio income

Gain or loss from investment property

Income from intangibles created by taxpayer

Personal service income

Income from covenant not to compete

Tax refunds

Recharacterized income

Activity of trading personal property for the
accounts of owners of the activity



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Activity - Definition and Importance

An activity is generally an “economic unit” that segregates or combines business undertakings

- Must be determined based on all facts and circumstances

Grouping (or not grouping) undertakings affects ability to deduct losses

- Level of participation determined for each activity
- Suspended losses allowed upon disposition of entire (or substantial portion of) activity
- Separate tracking of passive loss and credit carryovers required for each activity



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Restrictions on Groupings

Certain groupings not permitted

- Rental activities with other activities (unless one is insubstantial)
- Rental of real estate with rental of personal property
- Specific activities cannot be grouped by a limited partner: motion pictures, farming, leasing, oil and gas, geothermal deposits



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Consistency Requirement

Taxpayer may not regroup activities in subsequent years unless the original grouping was clearly inappropriate or there has been a material change in facts

Commissioner may regroup if taxpayer's groupings fail to reflect appropriate economic units and primary purpose was to circumvent section 469



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Seven Tests for Material Participation

More than 500 hours

Taxpayer's participation is substantially all

More than anyone else (and > 100 hours)

Significant participation activities exceed 500 hours

Nickel and dime test (5 of last 10 years)

Personal service activity (any 3 years)

Facts and circumstances (and > 100 hours)



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What is Participation?

Regular, continuous, substantial involvement

Generally, any work in an activity done by an individual (or spouse) who owns an interest in the activity

Exceptions

- Work not customarily done by owners if principal purpose is avoidance of section 469
- Work done as investor unless involved in daily operations



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Participation by Limited Partners

Generally considered passive, unless

- More than 500 hours
- Nickel and dime test
- Personal service activity

If limited partner also owns general partner interest, treated as general partner



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Participation Tests and LLC Members

LLC members may have limited liability for legal purposes (similar to a limited partner) but be considered a general partner for passive activity loss purposes

Recent Cases

- *Garnett*, 132 TC 19
- *Thompson*, 104 AFTR2d 2009-5381 (Ct. CL.)
- *Hegarty*, TC Summ. Op. 209-153



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Real Estate Professional Exception

Real estate professionals may treat all rental real estate activities as one activity

- Must qualify as a “rental” real estate activity under these rules

Election under section 469(c)(7)

- Made by attaching statement to return
- No requirement to disclose groupings (*see* Rev. Proc. 2010-13)



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Definition of Real Estate Professional

More than ½ of personal services performed in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates; *and*

Such taxpayer performs more than 750 hours of services in real property trades or businesses in which taxpayer materially participates



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Rental Real Estate Professional Exception

Personal services hours may include services
working as an employee

In case of a joint return, one spouse must
separately satisfy requirements

Extent of participation established by any
reasonable means



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Recharacterization of Net Income

Gains from formerly nonpassive activities

Rental of “nondepreciable” property

Equity-financed lending activity

Licensing intangible property

Incidental-to-development

Rentals to a related nonpassive activity

Significant participation activities

- Participation is > 100 hours but < 500 hours, and
- Total participation > 500 hours



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Disposition by Sale or Exchange

Fully taxable transaction to unrelated party --
All suspended losses are recognized

Fully taxable transaction to related party --
Suspended losses not allowed until activity
acquired by an unrelated party

Installment sale -- Suspended losses recognized
in same ratio as gain is recognized

Nontaxable exchange -- Suspended losses
generally attach to replacement activity

Partial disposition -- If disposition of
“substantially all” of an activity, taxpayer
may treat that part as a separate activity



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Other Dispositions

Gift -- Donor's losses eliminated; donee adds losses to basis

Death -- Suspended losses in excess of basis step-up upon death are allowed in final year

Divorce -- Same as gift

Abandonment -- Fully taxable transaction

Distribution by estate or trust

- No deduction by estate or trust
- Increase basis of activity immediately before distribution

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Other Considerations

Self charged interest rules

Working interest in oil and gas property held directly or through an entity that does not limit liability

Passive activity rules apply separately to each interest in a publicly traded partnership (PTP)

Consider alternative minimum tax adjustments

Worthlessness of partnership interest and complete disposition of activity rule



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Activity Reporting

Rev. Proc. 2010-13 requires taxpayers subject to passive activity rules to disclose:

- New groupings of two or more activities or rental activities
- Addition of new activity to existing grouping
- Regrouping, where original grouping was clearly inappropriate or material change in facts
- Partnerships/S corporations disclose activities annually as per tax return instructions

Rev. Proc. effective for tax years beginning on or after January 25, 2010

